Committee on Small Business
Access to Capital

FINANCING JOBS AND GROWTH

Report to
The Honourable Ernie Eves, Q.C.
Minister of Finance

February 1997

Ontario

COMMITTEE ON SMALL BUSINESS ACCESS TO CAPITAL:

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Committee Members:

Rob Sampson, Co-Chair, MPP
Joe Spina, Co-Chair, MPP
Jim Brown, MPP
Tom Froese, MPP
John O'Toole, MPP

Ontario

Committee on Small Business Access to Capital

Ontario

February 14, 1997

The Honourable Ernie Eves, Q.C.
Minister of Finance
7th Floor, Frost Building South
Toronto, Ontario
M7A 1Y7

Dear Mr. Eves,

In your 1996 Budget, you asked us to "...consider innovative ways to foster the establishment of private-sector financed equity funds that focus on new and emerging small businesses." We are pleased to submit the report of the Committee on Small Business Access to Capital entitled *Financing Jobs and Growth.*

During the course of our review, we concluded that to help promote jobs and growth, the Government needs to:

- Continue to reduce taxes, cut red tape and reduce regulations. This will allow small businesses to reinvest more of their hard earned dollars.

- Increase private-sector activity in the supply of capital by reducing regulatory barriers and institutional rigidities. Individuals, communities, financial institutions, venture capitalists, institutional investors and public capital markets all play a critical role in increasing the availability of capital for small business.

- Promote greater individual and community involvement in the financing of small businesses. This untapped source of capital could play a greater role in providing early stage financing to new and emerging small businesses.

We believe implementation of our recommendations will help usher in a new and dynamic era of small business financing in Ontario.

Sincerely Yours,

Mr. Rob Sampson, MPP
Co-Chair
Minister without Portfolio with
Responsibility for Privatization

Mr. Joe Spina, MPP
Co-Chair
Parliamentary Assistant for
Small Business

COMMITTEE ON SMALL BUSINESS ACCESS TO CAPITAL: "FINANCING JOBS AND GROWTH"

COMMITTEE MEMBERS

Mr. Rob Sampson, MPP Minister without Portfolio with Responsibility for Privatization	Co-Chair
Mr. Joe Spina, MPP Parliamentary Assistant for Small Business	Co-Chair
Mr. Jim Brown, MPP Scarborough West	Committee Member
Mr. Tom Froese, MPP St. Catharines-Brock	Committee Member
Mr. John O'Toole, MPP Durham East	Committee Member

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COMMITTEE ON SMALL BUSINESS ACCESS TO CAPITAL:

Report to the Minister of Finance

I. Introduction

The 1996 Ontario Budget Speech announced that:

> "...the Government will consider innovative ideas to foster the establishment of private-sector financed equity funds that focus on new and emerging small businesses. I have asked Mr. Rob Sampson... to lead this review and to report back to me. He will be assisted by Mr. Joe Spina... "

The Committee was co-chaired by Mr. Rob Sampson, then Parliamentary Assistant for Financial Institutions and now Minister without Portfolio with Responsibility for Privatization, and Mr. Joe Spina, Parliamentary Assistant for Small Business. At their request, Mr. Jim Brown, MPP, Scarborough-West, Mr. Tom Froese, MPP, St. Catharines-Brock, and Mr. John O'Toole, MPP, Durham East, joined the Committee.

Instead of duplicating the efforts of previous reviews, the Committee reviewed over 200 recommendations from recent studies on small business financing and discussed practical measures that could be taken to improve access to capital for small companies in Ontario. The Committee also received several briefings from staff in the Ministries of Finance and Economic Development, Trade and Tourism on a wide range of small business issues, including access to capital, financial institution regulatory issues and 1996 Budget initiatives.

This report summarizes the progress the Committee has made in meeting the mandate outlined in the Budget.

II. Background: Small Business Financing

Small Business: Key Source of Investment and Jobs

Ontario's small business sector is a key source of jobs and growth. The province has over 275,000 small businesses with fewer than 100 employees, accounting for 53 per cent of private sector employment and 98 per cent of all firms. Their contribution to the economy is becoming more important all the time:

- The small business share of employment has been rising over time. Small businesses currently account for 53 per cent[1] of private sector employment, up from 51 per cent a decade ago.

- Small businesses are job creators. During the 1980s expansion, firms with fewer than 100 employees created 946,000 net new jobs in Ontario – an average of 135,000 jobs per year. Small firms were hit relatively hard during the early 1990s downturn but are expected to provide a large proportion of future job growth in Ontario.

- Start-ups are critical to employment growth because they create more net new jobs than existing firms. A policy environment that is conducive to the start-up and growth of new firms will play a key role in job creation in Ontario.

Structural changes in the economy are increasing the potential for job creation by small firms. The long term shift in employment from goods- to service-producing industries is increasing small business growth opportunities. Large organizations using alternative service delivery mechanisms are spurring small business creation especially in business service industries. Technological change is also stimulating growth and job creation in small businesses.

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1 *Employment share is based on individual labour units, which are compiled by Statistics Canada from Revenue Canada files. Full-time and part-time jobs are counted equally (as one job). Self-employed people are counted as long as they pay themselves a salary.*

Some small firms are particularly strong contributors to the economy. They are different from other firms in two key ways:

- They have a unique product, service or way of doing business. Their source of growth can be new products, new ways of organizing production processes, creative marketing or original ideas.

- They grow faster than other firms (e.g. employment, output, profits).

These fast-growing, innovative firms can be found in all sectors of the economy. Their activities benefit other firms: they are important sources of sales and new business ideas. They also tend to rely more heavily on outside sources for "patient capital" (e.g. equity and long term subordinated debt), which is especially important for these fast growing, innovative firms.

Business climate and financing issues are often cited by small businesses as critical to their ability to grow and prosper. Among their concerns are:

- The availability of financing to support small business start-ups and business expansion.

- Reduced regulations and red tape to cut business costs and support economic growth.

- Deficit reduction and a favourable tax environment to help small business reinvest their earnings to create jobs.

The Committee is pleased that the Ontario Government is quickly implementing its proposals in the *Common Sense Revolution* to help small business and renew economic growth in Ontario. The Ontario Government has taken action by removing barriers to growth such as eliminating unnecessary regulations that have been restricting small business activity. It has cut personal income taxes and is eliminating the Employer Health Tax for small businesses. It is moving towards a balanced budget. Progress in these areas will improve access to capital by increasing retained earnings, facilitating lower interest rates and encouraging new investment and job creation. The box on the next page provides a list of the Ontario Government's accomplishments of particular interest to small business.

Provincial Government Actions Benefit Small Business

Reducing Regulatory Burdens

- The Labour Relations Act was amended to restore the balance in labour relations and the "quota law", the Employment Equity Act, was repealed.
- Ontario's minimum wage was frozen at $6.85 an hour.
- Workers' Compensation was reformed to put it on a sound financial footing.
- The Red Tape Review Commission reviewed all regulations to reduce the regulatory burden on business.

Ontario Tax Cuts Benefit Small Business

- Ontario's personal income tax rates have been cut on average by 15 per cent with another 15 per cent to follow.
- $400,000 of payroll will be exempted from the Employer Health Tax, exempting 270,000 or 88 per cent of Ontario's private sector employers.
- The Employer Health Tax is being eliminated for the self employed.
- 1-800 and 1-888 call centres have been exempted from Retail Sales Tax.
- Farm building materials have been exempted from Retail Sales Tax.
- Land Transfer Tax rebate was introduced for newly constructed homes.
- Film and Television Tax Credit has been introduced with enriched tax credits for first time film producers.
- Businesses can get a Co-operative Education Tax Credit for hiring Ontario post secondary co-op students.

Balancing the Budget

- The deficit for fiscal year 1996-97 is forecast at $8.2 billion, a cut of $3 billion or 27 per cent. The downward trend will continue until the deficit is eliminated by the end of the fiscal year 2000-01. This Balanced Budget Plan will stop the growth in Ontario's debt and will reduce debt as a share of GDP.

Small Business Access to Capital

Small businesses depend on capital from financial institutions, informal and formal venture capital providers, and public capital markets in order to start up their businesses, expand and contribute to economic growth. For example, according to a recent report[2]

- "Over one-quarter of all respondents reported that their access to capital is inadequate for at least one of the following uses: working capital, capital for buildings, machinery and equipment, or R&D, while an additional 29.5 per cent felt that their access to capital was somewhat inadequate...

- The incidence of inadequate capital ...is generally higher among very small firms...

- An estimated 28.4 per cent of companies that pursued outside equity were unable to obtain it. The rate was particularly high in the case of venture capital (51.7 per cent)."

Financial Institutions

Although banks recognize that small businesses are a key growth market, the prevailing view is that they tend to respond slowly to the specific capital needs of small business customers. For example:

- The Canadian Federation of Independent Business reports that "despite our current climate of very low interest rates and a growing economy, problems with the availability of financing for small business have remained at a very high level for several years"[3].

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2 *Canadian Labour Market and Productivity Centre with The Canadian Chamber of Commerce. Canadian Business Speaks Out on Access to Capital. March 1995. p1.*

3 *Canadian Federation of Independent Business. Statement to the Standing Committee on Finance on the 1997 Review of Financial Sector Legislation. September 24, 1996, p1.*

- Business also remains concerned about banks' high collateral requirements and their unwillingness to take risk[4].

- In Ontario, total bank credit outstanding to small businesses (credit authorizations up to $500,000) declined by 3 per cent during the first half of 1996 to $12.1 billion by June[5]. However, the major banks have been increasing the number of specialized business lending units which focus on lending to small and knowledge-based businesses.

- The major banks are also getting involved in providing venture capital, which is critical to the start-up and growth of small businesses. As a result of the 1992 changes to the Bank Act, the banks are now starting to make venture capital investments through specialized financing subsidiaries.

To help foster banks making venture capital investments in new and emerging small businesses, the 1996 Budget provided a Small Business Investment Tax Credit to banks providing patient capital to small businesses in Ontario. Banks that make long-term, unsecured investments in small businesses are able to earn back the temporary capital tax surtax imposed on the banks in the 1996 Budget.

In addition, the 1996 Budget announced that banks wishing to provide services to the Province will be required as part of their tender bid to show a comprehensive record of small business lending.

Small business access to capital is also improved as competition increases among financial institutions. New and competing financial institutions are expanding into specialized financing for small businesses such as asset-based lending which will help address some of the financing needs of small business.

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4 *Canadian Labour Market and Productivity Centre with The Canadian Chamber of Commerce. Canadian Business Speaks Out on Access to Capital. March 1995. p1.*

5 *Canadian Bankers Association. Business Credit Statistics, June 1996.*

Selected Quotations from Small Business Reports

" It did not matter whether it was a farm wife in Stratford, Sports Shop owner in Kenora, Carpet Manufacturer in Brampton or MBA student in Toronto, the issue of seed capital is rampant in Ontario. The noise surrounding this issue focuses around two areas: the chartered banks and how government can play a role in solving the problem of a lack of sufficient venture capital."

Joe Spina, MPP, 1996.

"Until their equity requirements are in the $1 million to $5 million range, the high administrative and due diligence costs faced by these investors (venture capitalists) make it uneconomic for them to provide equity financing in smaller amounts".

Canadian Federation of Independent Business and Canadian Chamber of Commerce, 1994.

"Mary Macdonald notes that venture capitalists rarely invest less than $500,000. In fact, others have claimed that private funds will not invest less than $1,000,000. Private funds avoid smaller investments because it is too difficult to research and keep track of a host of small companies."

Professor Jeffrey MacIntosh, 1994.

"Dominating the testimony on venture investment was the troubling scarcity of equity capital financing deals at the low end of the market, defined by some as equity capital requirements between $50,000 and $500,000, and by others as requirements below $1 million".

Standing Committee on Industry, 1994.

The Government is increasing the ability of loan and trust companies to offer small business financing. Loan and trust companies, which have strong records in community service and innovation, are currently prevented by Ontario regulatory rules from becoming more active in small business lending. For example, loan and trust companies registered in the province are prohibited from offering letters of credit and are subject to restrictions on investing in and lending to companies less than five years old. In addition, the statute describes commercial loans as payable on demand or in less than one year, impeding the ability of trust companies to provide longer-term commercial loans to Ontario businesses.

The 1996 Budget committed to take action to eliminate overlap and duplication in the regulation of the loan and trust industry. This would involve removing the outdated requirement that Ontario duplicate regulatory activities already undertaken by other jurisdictions in Canada. By harmonizing with federal regulations, an unnecessary layer of regulation is to be removed.

As a first step to achieving this, in October, 1996, the Minister of Finance released a discussion paper: *Commitment to Change: Eliminating Overlap and Duplication in the Regulation of the Trust and Loan Industry in Ontario*. Its goals were to ensure consumers continue to be protected, that companies can compete without the unnecessary constraints and costs of complying with two sets of rules, and that small business have greater access to capital.

Venture Capital

The Committee believes that in addition to these initiatives, there remains a need to help small businesses find investors who believe in their potential and are prepared to maintain their investment until that potential is fully realized. The greatest challenge faced by small business is the difficulty in obtaining venture capital. Venture capital is long-term financing which is generally not secured by assets and is invested in or loaned to a company by an outside investor. Venture capital is expected to achieve high rates of return to compensate for higher risk exposure.

Informal "Angel" Investors

Smaller venture investments are more often supplied through informal channels such as "love" money (personal funds of the business owner, relatives and friends) or "angel" investors. Angel investors typically have substantial business and financial experience.

Informal "angel" investors are a very important source of early-stage private equity financing for entrepreneurs and small businesses. The literature suggests that private equity markets for angel venture capital remain largely under-developed in Canada relative to the United States. There is also evidence that less than 10 per cent of investments by informal angel investors is followed on by formal investment by venture capitalists, suggesting a need for greater co-investment and networking among informal and formal investors.

The Committee sees an opportunity for better development of the informal venture capital market to help meet the financing needs of small businesses. The capital needs of new and emerging small businesses are particularly acute when it comes to obtaining seed and early-stage financing. Investments at these stages – arguably the riskiest of all venture capital and typically involving smaller amounts – are more likely to be made by angel investors who are a key part of the informal venture capital market. The Committee also recognizes that angel investors bring more than money to the table. Small businesses may also benefit from the business experience, contacts and managerial expertise of angel investors.

The Committee believes that the informal venture capital market in Ontario can and should be a more significant source of capital for growing small businesses. It recognizes the importance of developing networking facilities to bring more small businesses and angel investors together.

Formal Venture Capital

Formal venture capital providers tend to prefer larger deals because transaction costs per dollar of investment typically decline as deal size increases. Venture capital providers seek to identify and provide long term financing to companies with high growth potential.

The supply of formal venture capital has grown rapidly in Ontario in the 1990s, primarily as a result of federal and provincial personal income tax incentives for the Labour Sponsored Investment Fund program[6]. By 1995, LSIFs had $1.2 billion of capital under management, 50 per cent of the province's total formal venture capital pool. In that same year, LSIFs accounted for 38 per cent of the amount invested by the formal venture capital industry.

The formal venture capital industry invested $346 million[7] in the first nine months of 1996, surpassing the total investment in 1995 by $128 million (see Table 1). This increase was mostly concentrated on deals involving more than $5 million. These larger deals accounted for 61 per cent of the total amount invested, compared to only 39 per cent in 1995.

Ontario's supply of venture capital is low relative to its competitors. At the end of 1995, the amount of venture capital under management in Ontario was $233 per capita, compared to $1,189[8] in Massachusetts, $599 in New York, $502 in California and $385 in Quebec.

Although LSIFs have increased the available pool of venture capital and increased competition for more traditional venture capital providers, they have had a rather poor track record in investing tax-supported pools of capital. In part, the slow pace of investing was due to the combination of

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6 *Ontario Labour Sponsored Investment Funds (LSIFs) operate in a manner similar to mutual funds, using proceeds from the sale of its shares to invest in small and medium-sized Ontario businesses. Individual investors can invest up to $3,500 a year in an LSIF and receive a 30 per cent combined tax credit (15% federal and 15% Ontario).*

7 *All venture capital data are from Macdonald & Associates Limited.*

8 *Data for US states have been converted to Canadian dollars based on an exchange rate of 1.3717 Canadian $ per US $ (1995 annual average).*

Table 1: Ontario Venture Capital Investment Activity[9]

Deal Size	Number of Deals		Number of Investments		Amount Invested $ millions	
	1995	1996 9 months	1995	1996 9 months	1995	1996 9 months
Less than $1 million	62	43	69	52	24 (11%)	17 (5%)
$1 to $5 million	56	58	80	75	110 (50%)	117 (34%)
More than $5 million	20	37	34	73	84 (39%)	213 (61%)
TOTAL	**138**	**138**	**183**	**200**	**218**	**346**

the former legislative provisions and the fund managers maximizing legislative flexibility. In 1995, LSIFs invested $82 million in Ontario businesses.

The Committee notes that both the federal and Ontario governments have made significant changes to control the cost of the LSIF program. These changes included reducing the tax credit from 20 per cent to 15 per cent, reducing the individual investment limit from $5,000 to $3,500, extending the time investors have to hold their shares from five to eight years, and denying the individual tax credit eligibility for three years after shares have been redeemed.

In addition, Ontario tightened its investment rules and shortened the time period that funds have to make investments in small and medium-sized businesses. To encourage LSIFs to target smaller companies, a new small business investment requirement was introduced as part of Ontario's overall investment rules.

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9 *Macdonald & Associates Limited. Includes corporate, private independent, labour-sponsored and government funds. All dollar figures are rounded and totals may not add up.*

Partly in response to actions taken in the 1996 Ontario Budget, this situation has begun to turn around. LSIF investments have more than doubled to $180 million in the first nine months of the year. However, since the program's inception, Ontario LSIFs have invested $310 million or 38 per cent of their required level of investment. This is less than the total tax support of $460 million from the federal and Ontario governments since the program's inception in Ontario.

The Committee remains concerned about LSIFs' ability to target investments to where it is needed most – to small businesses with assets under $1 million. LSIFs account for about half of the venture capital under management but so far in 1996 they account for only 30 per cent of the amount invested in deals of less than $1 million. This is also a common problem found throughout the entire formal venture capital industry in Ontario. In the first nine months of 1996, the venture capital industry invested only 5 per cent of its total investments, or $17 million out of $346 million, in deal sizes of less than $1 million.

Public Capital Markets

The Committee also notes that the Government is committed to strengthening Ontario's globally competitive public capital markets to help foster Ontario business access to capital.

The 1996 Budget announced that, to make it easier for companies to raise funds in Canadian equity markets, Ontario would pursue an agreement with the federal government and with other interested provinces to delegate responsibility for securities regulation to a Canadian Securities Commission.

In October, 1996, the Ontario Securities Commission Task Force on Small Business Financing released its final report containing recommendations to facilitate equity financing for small and medium-sized business enterprises ("SMEs"). The recommendations would simplify the methods by which equity capital can be raised by SMEs in both private placements as well as the public markets. These initiatives include replacement of existing prospectus exemptions with "accredited investor" and "closely-held business issuer" exemptions, creation of a new simplified small business prospectus form, and other technical improvements.

Community Involvement in Small Business Financing

A significant challenge for the venture capital industry is to expand its outreach to small businesses in communities across Ontario, especially in communities outside established financial centres. Some communities are responding by helping to develop local networking and support infrastructure, which help small firms improve their market readiness and match them with formal and informal venture capital providers.

The boxes on the following pages list several examples and models of community-based approaches to improving access to capital. As communities, investors and financial institutions work more closely together, they could play a greater role in improving small business access to capital. As these groups learn to network and discover how to overcome financing barriers, small businesses will be better able to access capital at the community level.

The Committee sees an opportunity for the continued evolution of Ontario's venture capital market towards community-based venture capital funds that would target their investments to smaller companies. The small end of the market is under-served by existing venture capital providers. Community-based funds have a number of potential advantages:

- Local organizations and individuals could supply venture capital.
- There would be better matching of community-based funds and local investment opportunities as small businesses would be more willing to approach local venture capital suppliers.
- The transaction cost problem for investments in small businesses (high costs to set up a deal in relation to the size of the deal) could be reduced because local knowledge on the part of both venture capital organizations and small businesses could lower search and other information costs.

In summary, the Committee sees the most potential for improved access to capital for small businesses in community-based small business venture capital funds together with better support for angel investors.

Selected Community-Based Initiatives in Ontario

- The federal Community Futures program, established in 1986, set up investment funds operated by 58 Community Futures Development Corporations in Ontario. Based on initial federal funding of $86 million, loans, loan guarantees and equity investments of $200 million have been invested at commercial rates in 9,000 businesses, along with $375 million in owners' equity and other funds.

- The Ottawa-Carleton Economic Development Corporation (OCEDCO) offers investment match-making services which involve introducing possible investment opportunities to angel investors. These investments are pre-screened by staff and a volunteer investment advisory Committee. OCEDCO provides advice to entrepreneurs on their business plans, and hosts entrepreneur workshops, investor seminars, and investment showcases. Since 1990, OCEDCO has facilitated 45 matches representing $19 million in investment.

- The federal Canada Community Investment Plan request-for-proposals generated 18 responses from Ontario for demonstration projects for initiatives to facilitate access to risk capital for small and medium-sized companies. Five of the 11 selected for funding are from Ontario. The communities are North Bay, Sarnia-Lambton, Hamilton area, London, and Kitchener-Waterloo-Cambridge-Guelph.

  For example, the London Enterprise Development Corporation (LEDCO), is a community-based volunteer organization comprised of many of the city's business leaders. The intent is to mentor small business owners, assist them in developing business plans, provide information on various sources of financing and arrange introductions to potential investors through investor forums.

Selected Community-Based Initiatives in Other Provinces

- In Quebec, the Solidarity Fund (an LSIF) has committed $6 million per fund to the capitalization of 15 regional funds. (A sixteenth in Northern Quebec is being started). The Quebec government subsidizes administrative costs by $1.9 million over five years for each fund, while the National Bank of Canada has agreed to participate in seven regional funds by providing $600,000 to each fund. Investments by each fund typically range from $50,000 to $500,000, with an average investment of about $200,000.

- Quebec also has over 60 local funds Societes locales d'investissement dans le developpement (SOLIDES) sponsored by the Solidarity Fund and the Union of Regional and Local Municipalities of Quebec, with investments typically in the range of $5,000 to $50,000.

- Working Ventures Canadian Funds Inc. has invested $147,000 in PEI Capital Inc., along with local investors. PEI Capital is a community venture capital fund which will invest in successful, high-growth PEI businesses. The investment also gives Working Ventures the opportunity to co-invest with PEI Capital and to make follow-on investments.

- In 1993, Nova Scotia introduced three initiatives to assist different groups of small businesses obtain equity financing: the Nova Scotia Equity Tax Credit, Community Economic Development (CED) Funds and LSIFs. The following describes the CED initiative.

  The CED initiative offers an investor a 30 per cent provincial tax credit, in addition to a 20 per cent guarantee. Investments are also eligible for an RRSP deduction. The maximum eligible individual investment is $30,000 annually, and the maximum tax credit is $9,000 annually. The federal government does not provide a matching tax credit.

  An eligible CED organization can be formed by any group of individuals from within a community that feel they can obtain broad based community support for their community economic development plan. The CED organization can be a corporation or co-operative that raises capital by issuing shares to individuals and, in turn, invests that capital in local business entities.

  To date, one CED, set up as a cooperative, has been registered in Nova Scotia (Forest Trails Cooperative Ltd).

III. A Framework for Action

Access to capital remains a significant problem for many small businesses. The studies examined by the Committee found a financing gap for small businesses[10] requiring patient capital in deal sizes ranging from the low thousands to $1 million. As noted earlier, about 28 per cent of companies looking for equity capital were unable to obtain it. In the case of venture capital, the rate was 52 per cent.

Other relevant areas of concern identified in the studies included:

- Small businesses experience difficulty in accessing capital because of the high transaction costs to deal size ratio.
- Existing securities regulatory requirements for prospectuses add significant complexity and costs to small firms raising funds through traditional equity markets. These costs include:
    - Legal, accounting, regulatory and underwriting fees. Again, the problem is absolute dollar cost and transaction cost to deal size.
    - The time and resources required by the entrepreneur to comply with complex rules and regulations.
- Incomplete business plans and managerial inexperience can also act as an impediment to small business financing. There also appears to be a need to educate both the providers and some consumers of patient capital.

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10 *Small business can be defined in a variety of ways - on the basis of employment, sales, or assets. The Committee used assets of less than $1 million as the working definition during its deliberations.*

In developing its recommendations, the Committee identified the following key policy guidelines and objectives:

- The need to increase private sector competition in the supply of capital to small business **by creating the appropriate environment** to encourage new private sources and more financial institutions to lend to and invest in small businesses (e.g., create the legislative and regulatory environment to encourage loan and trust companies and credit unions and caisses populaires to play a more active role in investing in small firms).

- The need to increase private sector access to the various existing and new capital markets **by reducing the regulatory and institutional barriers** for small businesses wishing to access capital sources (e.g., initiatives recommended by the Ontario Securities Commission Task Force on Small Business to improve access to capital for small businesses).

- The need **to further reduce compliance costs and the paper burden** for small business to ensure that more internal resources are devoted to job creation and new investment rather than to government paperwork (e.g. Red Tape Review).

- The need **to continue with the government's agenda to cut taxes** (e.g. cuts to personal income tax, employer health tax, and Workers Compensation Board premiums), which will allow owner-mangers more after-tax income, so that they can increase the amount of retained earnings available to reinvest in the small business.

IV. Recommendations

Community Small Business Venture Capital Funds

1. The Committee recommends that the Government develop tax incentives to encourage the formation of Community Small Business Venture Capital Funds that would have a strong community and small business focus. These incentives would encourage investment in community-based small businesses with strong growth potential. A program framework could include the following key features:

   - Investments targeted to smaller deal sizes, such as investments of $250,000 or less in small businesses with up to $1 million in assets and revenue.

   - Incentives for investors triggered when investments are made in eligible small businesses, where appropriate.

   - Active community or group sponsorship including involvement of local business leaders and investors who can provide networking assistance and advice to small businesses.

   - Capital raised more broadly than from community or group sponsors.

   - Linkages to financial institutions where appropriate.

2. The Committee recommends that the Government pursue the concept of Community Small Business Venture Capital Funds with the federal government in order to secure matching incentives. Financial, small business, and community experts should be consulted about this proposal, and the Government should consider it as part of the 1997 Budget process.

Encouraging Informal Venture Capital for Small Business

3. The Committee recommends that the government develop measures to encourage investment in small businesses by angel investors. The parameters of these measures could mirror those of the Community Small Business Venture Capital Funds but should be tailored to the needs of the angel investors. The Committee further recommends that the government consult with the small business and financial communities on ways to help foster the role of angel investors in the economy.

Regulatory Reform

4. The Committee supports the 1996 Ontario Budget commitment to remove unnecessary regulatory barriers to the growth of Ontario's loan and trust industry. Loan and trust companies, which have strong records in community service and innovation, are currently prevented by Ontario regulatory rules from becoming more active in small business lending. For example, loan and trust companies registered in the province are prohibited from offering letters of credit and are subject to restrictions on investing in and lending to companies less than five years old. In addition, the statute describes commercial loans as payable on demand or in less than one year; impeding the ability of trust companies to provide longer-term commercial loans to Ontario businesses.

5. The Committee endorses the proposals for reform of loan and trust company regulation set out in the discussion paper released by the Minister of Finance in October 1996. In particular, the Committee supports the elimination of the "equals" approach, which requires companies incorporated federally and in other provinces to follow Ontario's restrictive standards. This will give loan and trust companies operating in the province the opportunity to offer a wider range of lending services and products to small businesses, and to compete more effectively in the business market.

6. The Committee supports efforts under way within the credit union/caisses populaires system to strengthen the ability of individual credit unions and caisses populaires to make use of their new lending powers to support small business.

7. The Ontario Securities Commission (OSC) Task Force on Small Business Financing recently recommended several initiatives to improve access to capital for small businesses. These initiatives include replacement of existing prospectus exemptions with "accredited investor" and "closely-held business issuer" exemptions, creation of a new simplified small business prospectus form, and other technical amendments. The Committee is encouraged by the direction of the OSC Task Force on Small Business Financing, and supports the reform of securities rules affecting small business financing.

Small Business Investment Tax Credit for Banks

8. The Committee supports the 1996 Budget initiative to help facilitate bank investments in small businesses. In reviewing this initiative, the Committee considered several changes to make the Small Business Investment Tax Credit for Banks more responsive to the financing needs of new and emerging small businesses. The Committee's recommended enhancements to the tax credit (identified in the following recommendations) will benefit Ontario's small businesses by targeting the incentives to smaller businesses to help them grow, prosper, and create jobs. As well, the improvements will encourage new dynamic relationships between banks and small business investment funds.

9. The Committee recommends that the small business investment tax credit, which was originally aimed at investments in qualifying small business corporations, also be extended to investments in unincorporated small businesses (sole proprietors and partnerships). This will significantly expand the number of small businesses which can benefit from this credit.

10. The Committee further recommends that the small business investment tax credit be extended to investments in qualifying "small business investment funds" that invest in small businesses with assets and revenues no greater than $5 million.

11. To help ensure that the tax credit targets smaller businesses, the Committee endorses phasing out the tax credit as the size of the business increases. Accordingly, the Committee fully supports the budget announcement of phasing out the credit for investments in businesses with assets or gross revenues between $1 million and $5 million, so that the maximum rate would apply only where the assets and gross revenues of the small business (including associated businesses) do not exceed $1 million.

12. In recognition of the higher transaction costs associated with smaller investments, the Committee recommends that the credit be doubled for investments of $250,000 or less. This will help target the incentive to smaller deal sizes, where access to capital is more difficult. The Committee further recommends that this enhanced rate be phased out for investments between $250,000 and $1 million.

Labour-Sponsored Investment Funds

13. The Committee also supports the 1996 Budget changes to the Labour Sponsored Investment Fund (LSIF) program. These changes will ensure that more capital is available for small Ontario businesses on a more timely basis and at a reduced cost to the taxpayers of Ontario.

14. The Committee considered and recommended a number of refinements to the LSIF legislation. These recommendations formed part of Bill 93: The Good Financial Management Act, 1996 which received Royal Assent on December 9, 1996. The Committee recommended that the legislative wording of the 10 per cent small business requirement be clarified to ensure that the investment level is maintained beyond the initial investment period. The Committee also recommended that a number of technical, legislative amendments to Bill 70: The Tax Credits and Economic Stimulation Act, 1996 be introduced to provide technical clarification to some of the Budget initiatives.

15. The Committee recommends that the Government further examine the cost and performance of LSIFs, taking into account the response of the funds and investors to the changes announced in the 1996 Budget. The Committee is particularly concerned about the ability of LSIFs to more effectively target small businesses in need of early-stage funding. The Committee recommends that consideration be given to allowing the LSIF program to become a subcomponent of the Community Small Business Venture Capital Fund program.

Role of the Federal Government

16. The Committee recognizes the importance of federal cooperation and participation in providing tax incentives to encourage individual Ontarians to participate in the venture capital market. Since both the federal and provincial governments have an interest in ensuring that tax-supported incentive programs provide the maximum possible economic benefits for the money spent, and since some of the Committee's recommendations may require federal as well as provincial action, the Committee recommends that the Province initiate discussions with the federal government on their participation in these recommended initiatives.

Importance of Monitoring and Consultation

17. Since market conditions are changing and the effectiveness of government programs and incentives change with market conditions, the Committee recommends that the Ministry of Finance regularly review the Government's measures to improve access to capital and that there be further consultations with small business representatives, the investment community, and venture capital experts in the pre-budget period.

V. Conclusion

The Committee is pleased to have had this opportunity to examine a very pressing concern for many small businesses – access to capital – and to make a series of recommendations to the Minister of Finance for government action. The Committee appreciates that the Government has already undertaken many initiatives to benefit small business in recognition of the small business sector's role as a major source of investment and jobs. The Committee believes that the adoption of its recommendations will provide a major additional stimulus to the small business sector.

The Committee invites public comment on its report. Comments should be sent by March 15,1997 to:

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